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DUBLIN LONDON GENEVA

Family Office of the Year 2017
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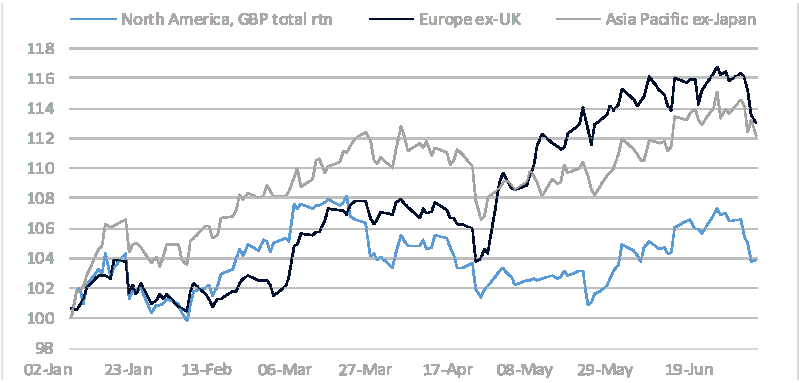
GLOBAL INSIGHT

Overview

- Our interest in longer term investment trends is highlighted by our feature article by Builders Union looking at the impact that millennials may have on the real economy and financial markets.
- Every week more than one million millennials (born between 1981 and 1997) replace retiring baby boomers (born between 1946 and 1964) in the global workforce.
- As millennials come of age, their impact on consumer markets, company performance and investor portfolios will be substantial. This shift creates a major investment opportunity.
- In the Macro View, we still see positive global growth continuing, even if momentum slows in H2 17.
- The overall theme highlights the change in central banks' stance from accommodative to tightening rates and withdrawing quantitative easing.
- The conundrum for Central Banks is the lack of wage growth despite the perceived tightness of the labour markets.
- In the Investment Outlook, we point to the benign backdrop of low volatility and slow growth that is underpinning equity market performance so far this year.
- We expect equities to find support in the medium term based on their relative valuation to Government bonds and the benign economic backdrop which has also tightened credit spreads to multi-year lows.
- Our conclusion is that we would expect to see monetary stimulus gradually withdrawn in H2 17, leading to higher Government bond yields although equities should find support from growth and higher inflation but with a higher level of market volatility.

Europe-ex UK equities significantly outperform in Q2 2017



Inside this issue

Economic Highlights

- The global economy is set for positive growth and low but rising inflation
- UK growth destined to match Japan in 2017 at 1.2%
- The eurozone recovery has been impressive with growth expected to be 1.9% in 2017
- US economy is set to grow by 2.1% in 2017 but the Fed's projected path is threatened by stalling inflation

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Key Issues in Charts

GBP/EUR 12 Months to Date

- The UK General Election result increases the threat of a disorderly exit from the EU as reflected in weakened sterling.
- We can expect increased volatility as markets and political circles monitor Theresa May's credibility as Prime Minister and leader of the Conservative Party.
- Contradictory signals from the BOE as to the future path of interest rates will also add to the uncertainty for the currency.

S&P 500 Historic P/E Ratio

- The S&P500 trades on a forward P/E of 17.6 times which is close to the highest level since 2004.
- Cyclically Adjusted P/E's (CAPE) are up to 28.0 times higher than any time since the tech bubble in 2000. History suggests that a level above 30.0 times usually leads to a decline in US equities.
- In relative terms the index trades at an approximate 30% premium to Global equities which is the highest valuation gap since 2008.

Baseline Taylor Rule Estimate for the US

- The Taylor rule tries to establish a level for short term interest rates from the cyclical level of inflation combined with the divergence of employment from the perceived neutral rate.
- It seems clear that fundamental models such as the Taylor rule are pointing towards higher rates and the phasing out of QE.
- The change in major Central Bank rhetoric would indicate that we have reached an inflection point where loose monetary policy will start to be reversed through the tapering of QE and the normalisation of interest rates.

The Millennial Generation: An Investor's Playbook For The Greatest Demographic Shift in History

by Builders Union Journal, July 2017

The rise of the millennial consumer may well be the most profound demographic shift in history. Yet amidst the daily news on technology, geopolitical tensions and market volatility, longer term trends such as generation change are easily overlooked. When investors do focus on demographics as an investment theme, the "silver dollar" of aging populations is generally front of mind – with young consumers dropping from the radar screen.

*"When investors do focus on demographics as an investment theme, the **"silver dollar"** of aging populations is generally front of mind"*

MILLENNIALS MATTER

Every week, more than one million millennials (born between 1981 and 1997) replace retiring baby boomers (born between 1946 and 1964) in the global workforce. The world's biggest cohort of their time is passing the baton to the biggest generation of today. 2.0 billion millennials and 2.4 billion centennials already make up a combined 60% of the global population and will provide 75% of the world's workforce by 2025.

Baby boomers transformed the global economy as they grew up, straining resources, creating bottlenecks and fanning inflationary fires. For investors, a "boomer consumer" portfolio of cars, suburban real estate and home improvement, big label fashion and department stores, personal care brands and Japanese electronics generated double-digit returns over a 25 year time period from 1985 to 2010. The demographic dividend enjoyed by and created by baby boomers held firm during the 1987 markets crash, the savings and loan crisis, the burst of the dotcom bubble in the late 90s and the global financial crisis of the late 2000s.

Similarly, as millennials come of age, their impact on consumer markets, company performance and thus investor portfolios will be substantial. The shift creates a major investment opportunity: a long-term secular growth trend driven by demographic fundamentals. Companies that cater successfully to the millennial *zeitgeist* of experience, authenticity, connectivity, minimalism, analog and digital and health are bound to deliver long streaks of growth and investor returns.

"as millennials come of age, their impact on consumer markets, company performance and thus investor portfolios will be substantial"

Conversely, ignore or underestimate two billion millennials at your own peril: the steadiness of the trend should not take away from the magnitude of change that this generation is going to lead. The world in 2027 will look very different from today.

WHAT MAKES THEM DIFFERENT

Millennials grew up in the most peaceful time in history, with the Berlin Wall, the Cold War and the price of air travel falling in rapid succession. The world became a global village, driving a boom in consumerism and cheap manufacturing. Millennials experienced abundance of choice in almost everything from

Figure 1: Overview of Generations

Generations (2017 data)	Silent Generation	Baby Boomers	Generation X	Millennials (Gen Y)	Centennials (Gen Z)
					
Birth Date / Age	'23-'45 / 71-92y	'46-'64 / 52-71y	'65-'80 / 36-52y	'81-'97 / 19-36y	'98-'17 / 0-19y
Population / %	0.3bn / 5%	1.1bn / 15%	1.5bn / 20%	2.0bn / 28%	2.4bn / 32%
Key life event	World War II	Cold War	End of Cold War	9/11, Soc'l Media	Rise of AI, Trump
Communication	Letter	Telephone	email & SMS	Instant message	Emojis
Key technology	Car	TV	PC	Smartphone	Virtual reality
Digital proficiency	Pre-digital	Digital immigrants	Early adopters	Digital natives	Digital naturals
Home	Retirement home	Detached house	Own flat	Flatshare	Parents' House
Music	Jazz / Classical	Elvis / Beatles	Nirvana	Beyoncé	Justin Bieber
Social network[1]	Rotary Club	Match.com	LinkedIn	Tinder	Snapchat
Deepest Fear	The world in 2017	No longer center of attention	What about my generation?	Paying off student debt	Slow wi-fi & Low batteries

Source: Bank of America Merrill Lynch

*"Most crucially, millennials grew up in the **age of the internet** – and that changed everything"*

shampoo brands to cars. Choices that have extended to education and have led to a generation with more college degrees than their parents could ever have dreamt of. Environmental concerns, most notably climate change, have been a core pillar of the curriculum since primary school. Most crucially, millennials grew up in the age of the internet – and that changed everything.

Where baby boomers bought the same products from the same stores for years, millennials search and shop online: food, movies, clothes, electronic equipment – even relationships. They travel by phone via Uber, pick their accommodation online at Airbnb, and find their next date on Tinder. Where baby boomers kept up with the Joneses by buying homes in the suburbs, station wagons and record players, millennials rent, swap and share – and stream their music on Spotify.

MILLENNIALS: 15% INCOME GROWTH PER ANNUM

In case of millennials, there is obviously some truth to a tough economic backdrop for the 1981-1997 generation in the US and Europe. The financial crisis and subsequent anaemic recovery, youth unemployment, strict labour laws and soaring rents have hit millennials disproportionately hard. *Forbes* magazine found that US millennial average purchasing power is 20% lower than their parents.

However, millennial incomes are growing strongly, and will continue to do so over the next decade. Dissecting long-term US and UK tax return data by cohort, we found that age and education are the two biggest drivers of personal incomes. Given the average millennial is currently only 27 years old, they are – over the next two decades – steadily approaching their earnings peak in their late 40s. In addition, this generation is the most educated generation in history with record number of students and the highest college participation rates. This is reflected in lower earnings for millennials in their twenties, largely explaining the difference in current purchasing power to their baby boomer parents back in the days. However, more education usually translates into a steep-

er slope of incomes later in adult lives as academics play 'catch up'. While the present may be financially tough for a lot of millennials, the future looks bright. We project an annual 15% income growth for the millennial generation until 2027. In other words, we believe millennials will see their incomes quadruple over the next ten years – the compounding effect is dramatic over a longer time frame.

*"technology has fundamentally altered the way humans think about basic concepts such as **time, space, trust and relationships.** Millennials solve problems and consume differently from their parents. "*

HOW TO INVEST IN MILLENNIALS

Millennials are difficult to grasp for more seasoned investors – technology has driven a wedge between "digital immigrants" (baby boomers and to some extent generation X) and "digital natives" (millennials and centennials). We believe that technology has fundamentally altered the way humans think about basic concepts such as time (moving faster), space (global village), trust (between strangers) and relationships (more connections and more communication). Millennials solve problems and consume differently from their parents. Yet, there is overwhelming data that shows underlying human desires of finding meaning, belonging and self-actualization are very much unchanged.

Investing behind millennials is harder than with baby boomers. Millennials are more selective than their parents in how they spend. They value experience, purpose, authenticity, connectivity, minimalism, urban culture, privacy, play, health, transparency, convenience, access over ownership, curated choice and a good deal. Conversely, we believe millennials will prove a challenge for traditional models that fail to deliver on abundant choice (free to air and cable TV), convenience (big box retail and shopping malls), environment and purpose (cars), health (alcohol and tobacco), transparency (financial services), value (flag carrier airlines) and experience (hotel and restaurant chains). The ripple effects will be felt across a majority of sectors: Taking cars as an example, millennials' preferences for access over ownership (shared mobility), sustainability (electric drive) and technology (self-driving cars) will pose headaches to parking lot operators, oil majors, insurance providers, infrastructure operators and machinery manufacturers.

With millennials being so selective in their consumption habits, winners and losers are bound to emerge. A tracker fund (such as a global consumer sector ETF) is therefore unlikely to provide pure play exposure to the demographic trend. A "smart beta" thematic strategy would rely on quantitative screening to pick a portfolio, missing the nuances of consumer motivations and behaviours. By the same token, investing in technology stocks is not a great proxy for investing behind young consumers: millennials are often agnostic between digital and analog channels, or prefer the feel, tradition and authenticity of the "real", offline world.

"With millennials being so selective in their consumption habits, winners and losers are bound to emerge"

After all, we believe the best way to capture demographic change and invest behind millennials may be to engage with them, ask questions and learn about their lives – and perhaps pick up some investment ideas along the way.

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i Bank of America Merrill Lynch: New Kids on the Block – Millennials & Centennials Primer, August 2016, Sarbjit Nahal et. al.

Macro View

Global economic growth seems set to continue to be positive, even if momentum were to slow in H2 17 with central bankers anticipating wage inflation that has so far been noticeable by its absence. The pickup in trade and investment would suggest that world growth is now forecast to be a more sustainable 3.2% in 2017.

*"The BOE voted to keep rates unchanged at 0.25% at its June meeting but by a majority vote of **only 5:3**"*

UK – The last time the bank of England (BOE) raised interest rates was July 5, 2007 before there was any concern about the possibility of a global financial crisis. A decade later it would seem that the Monetary Policy Committee (MPC) is once more contemplating action.

The BOE voted to keep rates unchanged at 0.25% at its June meeting but by a majority vote of only 5:3 citing that it had reduced tolerance to above-target inflation due to diminished spare domestic capacity and stronger international growth. The May Inflation Report and market economist argue that 2.9% inflation is driven by the depreciating pound so is temporary in nature.

Economic data releases suggest that the weak economic performance of Q1 17 may actually be a medium term trend due to the effects of the BREXIT. The decision has caused markets to readjust expectations over the next 12 months assuming that economic pressures do not continue to deteriorate.

Furthermore, the BoE gave notice that it would raise the banks' counter-cyclical capital buffer for UK risk-weighted assets by 1% by year end. The BoE has become increasingly concerned about non-mortgage borrowing. Data underlines the pressure on UK households with the savings ratio falling to 1.7%, the lowest on record, and consumer credit growing at 10.3%. Furthermore, the effects of a 0.8% fall in real wages are clearly being felt on the high street.

UK GDP for Q1 was an unrevised 0.2%, the weakest in a year down from 0.7% in Q4 16 leaving full year 2017 growth at 1.2% in line with Japan. May industrial production and construction output figures were poor but the significant downturn came in retailing with growth moving from 4-5% year-on-year to 1-2% year-on-year. Negative business surveys also blame the fall in household incomes for weaker demand as consumers hold back.

Theresa May's gamble on an early election has monumentally backfired which will have an effect on BREXIT negotiations with an increased threat of a disorderly exit reflected in weakened sterling and underperforming domestic stocks. Over the short term we see risk of the UK going to the polls again in Q4 17 with the real prospect of an election upset.

*"The US economy looks set to deliver **2.1% growth in 2017** after a weak 1.6% in 2016"*

United States – The US economy looks set to deliver 2.1% growth in 2017 after a weak 1.6% in 2016 according to the OECD and in line with forecasts. Recent data releases point to a weakening in soft data, in line with our view that sentiment is far more positive than actual economic performance particularly the continuing absence of wage inflation.

The Federal Open Market Committee (FOMC) voted to raise the target range of the federal funds rate by 25bp from 1.0% to 1.25%, the second of three hikes forecast for 2017 during its June meeting. The FOMC described policy as accommodative, meaning it can do more to continue the gradual removal of

loose policy. Observers favour a pause in tightening in September and instead a balance sheet drawdown announcement leaving the final hike of 2017 until December.

The Federal Reserve's projected path for the economy is threatened by stalling inflation; core inflation fell to 0.8% year-on-year in May creating a significant headwind although the FOMC pushed up its forecasts for economic activity, household spending and wages.

Euro Area – The recovery in the eurozone has been impressive with growth expected to be 1.9% in 2017 as the improving labour markets support real wages and optimism grows for Macron led reforms. Economic slack coupled with rising inflation expectations should see full year 2017 inflation mirror growth at 1.9% with the European Central Bank (ECB) withdrawing monetary accommodation without raising rates this year.

*"recovery in the Euro-zone has been impressive with growth expected to be 1.9% in 2017 as the improving labour markets support real wages and optimism grows for **Macron**-led reforms."*

Following the June ECB meeting a small change to its forward guidance was made by dropping the reference to lower rates and the assessment of risks was upgraded to broadly balanced leaving investors expecting that the natural progression to the tapering of quantitative easing (QE) will be in September representing further tightening from the central bank fraternity. A European government bond taper tantrum reaction in H2 17 could be significant with so many issues trading in negative territory.

Japan – In contrast, the Bank of Japan's June meeting statement underlined its continued commitment to its QE programme and is unlikely to tighten until this time next year. Governor Kuroda referred to the continuing weakness of CPI and inflation expectations having experienced such a long time living with deflation. In the June Reuters Tankan Survey both manufacturing and non manufacturing sentiment increased significantly. GDP growth for 2017 is forecast to match the UK at 1.2%, the noticeable trends of this recovery have been that growth appears to be driven by domestic demand and increased exports to Asia; however, the struggle to create inflation remains the biggest challenge for Kuroda and Prime Minister Abe whose poor showing in Tokyo metropolitan elections could be significant in 2018.

China – The slowing of Chinese GDP from a rate closer to 8% in 2016 to the 6-6.5% official target rate in 2017 will be a significant headwind for global growth as the overheating housing market is dampened down. This will have an effect on Asian exports and have further implications for global commodities. The authorities have largely concentrated on excessive borrowing and speculation by maintaining a tightening bias through increasing short term rates.

"The slowing of Chinese economy will be a significant headwind for global growth"

Conclusion – The global economy has experienced a reasonably rare synchronised recovery boosted by Chinese stimulus in 2016 and the expectations of US fiscal changes. However, headwinds may be created in H2 17 as central banks move towards a tightening bias and the Trump administration policies fail to meet market expectations.

Investment Outlook

Source: Institutional Advisors, Fed Stimulation

*"The currency markets were dominated by the **decline in the US dollar**"*

The benign environment for investment markets continued into Q2. Against a backdrop of record low volatility, global equities rallied 3% to extend the gain for 2017 to 8%. On aggregate, global government bond yields ended the quarter lower. However, a sharp sell-off in the last week of June in response to some hawkish rhetoric from the European and UK central banks saw the yields on their respective 10-year paper rise over the period. The currency markets were dominated by the decline in the US dollar, driven by a scaling back of expectations surrounding the 'Trump Trade', softer US economic data and a recovery in Europe. As we move into the second half of the year, the question is whether the febrile reaction of markets to the prospect of tighter monetary policy is a sign of things to come.

The US Federal Reserve (Fed) would appear to be in the glass half-full camp. It raised its key policy rate again in June, to target a range of 1.0% - 1.25%. Yet since the beginning of the year, a period in which there have been two rate hikes, overall monetary conditions have eased with lower Treasury yields, tighter credit spreads and a weaker dollar. The Fed would appear to be taking the view that any weakness in inflation is temporary, and the tightness in the labour market will result in higher wages, which in turn will require further rate increases. If it is wrong then it may struggle to implement its plan to raise rates by up to another 175 basis points over the next two years. If it is right, then the bond market is heading for a correction with 10-year Treasury yields likely to head towards 3.0% from the current level of 2.3%. The Fed has also flagged that it will start to reduce the amount of balance sheet reinvestment as Treasury and mortgage-backed securities mature from September, which will reduce demand, albeit marginally. US politics may also have its part to play in the bond market; with mid-term elections due next year the US Administration may be incentivised to pursue the tax reforms, which would likely see growth expectations increase, together with US bond yields.

"The Fed would appear to be taking the view that any weakness in inflation is temporary, and the tightness in the labour market will result in higher wages, which in turn will require further rate increases."

In Europe, economic growth is improving but there is still spare capacity whilst core inflation remains some way shy of the official 2% target. However, while the European Central Bank (ECB) may not appear to be under any pressure to act, technically it needs to reduce its purchases as it is reaching the prescribed limits of its bond buying programme. Therefore, the hawkish commentary from Mario Draghi, ECB president, at the end of the quarter was probably a shot across the bows for investors. Tapering is on the horizon, either in the latter part of this year or early next, albeit at a gradual pace.

In the UK, the economy has held-up well in the wake of last year's referendum, but with the official negotiations with the European Union only having just begun there is much uncertainty. The result of June's election has certainly not strengthened Britain's bargaining position and would suggest that the public mood is for less austerity. Consequently, outside of the Bank of England reversing the July 2016 post-Brexit 25bp rate cut, interest rates are unlikely to move higher. But gilt prices could be vulnerable if investors believe the government is willing to run a looser fiscal policy.

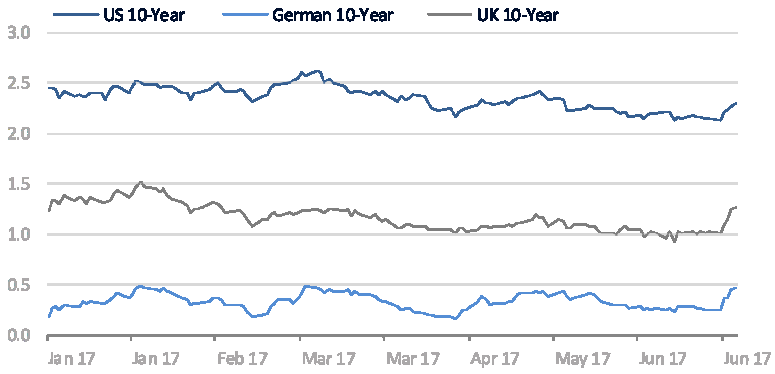
In credit markets, falling rates, low volatility and rising equity markets combined to tighten spreads over government bonds to multi-year lows. But while corporate bond markets have been benign there are potential risks. The Securities Industry and Financial Markets Association, for example, flagged that corporate leverage is 57% above the last peak in 2008, with higher risk borrowing increasing during the past year. However, for the time being corporate bond investors remain relatively sanguine about the economic prospects, a view that has been shared by equity investors.

The latest leg of the equity market rally can, in part, be attributed to an inventory shortage brought about by the surprisingly strong pace of Chinese growth in the second half of 2016. As a result, the first quarter reporting season was globally positive with companies registering double-digit earnings growth year-on-year. From a sector perspective, the greatest optimism was concentrated in technology, arguably the bellwether of the modern economy. On the other hand, retailers have started to raise red flags and have been subject to downgrades for this year and next.

Looking ahead, some caution may be warranted as global growth is solid but showing signs of slowing, inventories are being restored and pricing power is being reined back. But the broad economic backdrop remains fairly benign, and coupled with the better relative valuation versus bonds, equities should continue to find support in the medium term.

*"The international Monetary Fund has calculated that **10% of US corporate assets are already struggling to meet interest payments** out of current earnings."*

10-Year Government Bond Yields (year to date)



Source: *Bloomberg*

In terms of regional valuations, US equities as measured by the S&P500 index trade on a forward price-to-earnings ratio (P/E) of 17.6 times, close to the highest level since 2004, according to FactSet. In relative terms, the index is trading at almost a 30% premium to the rest of the world, which is the highest since 2008. Company profit margins are at historically high levels and the business cycle is getting long in the tooth. It is notable that US buybacks have fallen by 20% during the past year, which could be indicative that company executives are seeing less value in their own stock. On a positive note, some form of tax plan from the Trump administration should see US stocks appreciate further, and with the recent rally being driven by a narrow section of the market,

"US equities trade on a forward price-to-earnings ratio (P/E) of 17.6 times, close to the highest level since 2004"

predominantly technology, there remains value in certain sectors including financials and healthcare.

"The environment for European equities is improving and earnings forecasts for this year have been upgraded"

The environment for European equities is improving and earnings forecasts for this year have been upgraded, something investors have not seen for a while. In fact, earnings growth in the region is expected to outstrip that of the US this year. Meanwhile, M&A activity has picked-up and fund flows into the region turned positive in Q2, a trend we would expect to continue.

*"recent **sterling weakness should be broadly positive** for translated earnings"*

The UK faces its own challenges with Brexit negotiations having just begun and with a government weakened by the General Election result. However, as often quoted, 70% of FTSE100 revenues come from abroad, therefore recent sterling weakness should be broadly positive for translated earnings. In addition, from a technical perspective the UK offers the highest dividend yield of the main regions while the yield gap versus government bonds is the most attractive. The more domestically oriented FTSE250 index could struggle until Britain's future relationship with Europe becomes more transparent, but this has been discounted somewhat with valuations on domestically focused stocks having retraced towards their financial crisis lows.

Japan is widely viewed as a pro-cyclical market that performs best when bond yields are rising and the yen is depreciating. With neither of these scenarios being played-out it should come as no surprise that the Nikkei 225 index has lagged this year. However, Japanese stocks are relatively attractive on a forward P/E of 14 times and a tangible price-to-book ratio of 1.5 times (compared to the US on 8.7 times). Further, Japanese boards are slowly becoming more accommodative of overseas executives with the likes of Sony, Panasonic and Toyota considering hiring international talent rather than the traditional reliance on seniority-based management.

Emerging markets have rallied strongly this year, outperforming global equities by some 10%, buoyed by the combination surprisingly strong Chinese growth and a depreciating US dollar. However, the second half of the year may prove to be more challenging with global activity likely to slow.

"oil moved sharply lower during the second quarter, with Brent closing at $48"

In commodity markets, oil moved sharply lower during the second quarter, with Brent closing at $48, despite OPEC's decision to extend production cuts by nine months. A number factors contributed to the bearish sentiment including the Saudi-Qatar spat which could hurt supply-side cohesion, stubbornly high inventories and the risk of increased supply from US shale. However, the oil price should find support at current levels as demand is expected to exceed supply in 2017 for the first time since 2013 and inventories are forecast to trend lower, albeit from a high level.

In summary, during H2 we would expect monetary stimulus in its various forms to be gradually withdrawn, which should lead to higher government bond yields and an increase in equity market volatility. However, equity markets should find support from stable global growth and a pick-up in inflation.

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